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Leveraging intangible assets: how a rating can help measure and communicate performance

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With a sturdy stride the elephant in the room is taking center stage. Intangible assets have in recent years become the focus of companies, financial analysts, investors, accountants and regulators alike in attempts to understand and narrow the gap between a company's book and market value. For most companies, intangible assets today are a major value driver and account for more than tangible assets; research estimates that between 70% and 85% of all assets are intangible¹ but they go largely unaccounted in financial statements. For example, the balance sheet assets of Coca-Cola or Microsoft account for less than 5% of their total value.²

Quantifying intangible assets has long presented a challenge for accountants and financial analysts. Different approaches compete on how to define, classify and incorporate these assets within mainstream accounting and valuation. As non-physical claims to future value or benefits, intangible assets include reputation, goodwill, brands, intellectual capital, organisational capacity for innovation, corporate culture, quality of management systems and the ability of management to navigate and compete in an increasingly complex business landscape. While a market for certain intangible assets, such as brand and goodwill, is created when a business changes hands, it is generally considered incomplete.

So why the growing interest in intangibles and why now? As equity prices have increased beyond the intrinsic value of the underlying companies, the need to explain and justify these valuations has become more urgent for financial analysts. In other words, it has become important to differentiate between true long-term intangible value and short-term speculative investment.

Understanding how intangible assets can create future value may arguably lie at the heart of the business case for corporate responsibility. Much of the activity and effect of integrating corporate responsibility principles into operations – and managing related risks – are mediated through intangible resources and processes.

¹ Hand, J. and Lev, B.(eds) (2003) 'Intangible assets – values, measures, and risks', OUP; www.interbrand.com; According to recent analysis of the US market by PWC, intangible assets and goodwill constituted 74% of the average purchase price of acquired companies in 2003. PWC (2005) 'Reporting the value of acquired intangible assets', London UK.

² www.interbrand.com

Changing perceptions of risk to value

There is growing consensus among European analysts and asset managers that corporate responsibility and governance issues affect shareholder value both in the short and long term, either positively or negatively (In comparison, US and Asia-Pacific analysts still generally appear reluctant to publish reports to this effect, most likely due to a lack of resources and fear of litigation). A report published in June 2004 by the UNEP Finance Initiative Asset Management Working Group³ showed that even sell-side analysts – with their focus primarily on the short term – are showing significant interest in finding ways to estimate the materiality of corporate governance and responsibility issues to equity pricing.

Since then, the equity research departments of Société Générale, WestLB and UBS are among those publishing new reports to show how they are modelling corporate responsibility and governance risks and integrating these dimensions into their mainstream research to assess the potential impact on shareprice performance.⁴ While each takes a slightly different approach – WestLB emphasises the information coefficient, Société Générale underlines the use of betas, and UBS focuses on liabilities and cost of capital – the signal is the same: companies' ability to manage corporate responsibility and governance risks will increasingly form part of mainstream financial analysis.⁵ This is reflected in a recent survey of 195 global investment managers with USD 30.5 trillion in assets under management (AUM): more than 70% believe that integrating environmental, social and governance issues into analysis will become mainstream in 3-10 years.⁶ Others, such as the new investment firm Generation Investment Management (led by Albert Gore), go so far as to say there is no difference between fundamental equity research and sustainability research.⁷

Compelling evidence of how corporate responsibility and governance risks can significantly affect shareprices is steadily accumulating: French manufacturer St. Gobain saw its shareprice fall 50% over a few months in 2002, when it admitted its asbestos-related litigation risk and investors showed aversion to the share. Three years later, legal proceedings are underway, but analysts have factored the asbestos risk into their forecasts and the share has returned to its 2002 level.

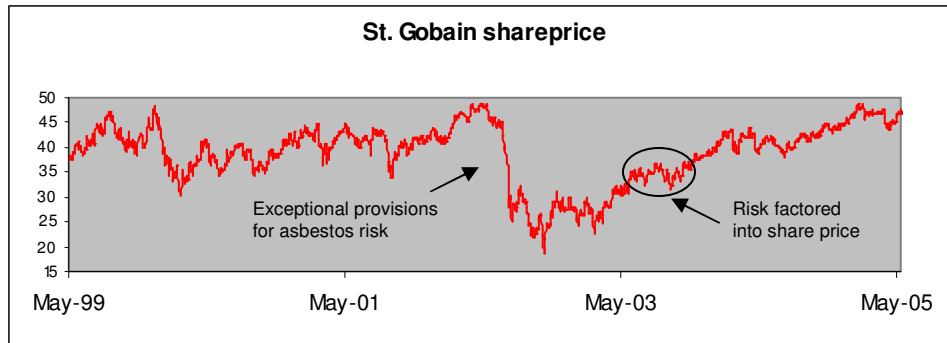
³ UNEP Finance Initiative Asset Management Working Group (June 2004) 'The materiality of social, environmental and corporate governance issues to equity pricing', Switzerland. The following brokerage houses submitted reports on the topic: ABN Amro, Deutsche Bank, DKW, Goldman Sachs, HSBC, NikkoCitigroup, Nomura, UBS and WestLB.

⁴ Société Générale in partnership with CoreRatings (April 2005) 'SRI impact on valuations', Paris France; WestLB (March 2005) 'Values at risk: Introducing a non-financial risk navigator', London UK; UBS (April 2005) 'Why try to quantify the unquantifiable?', London UK.

⁵ Albeit in some cases through external financial incentives: In 2004, a group of European institutional investors with EUR 364 billion in AUM (USD 445 billion) launched the Enhanced Analytics Initiative to persuade sell-side analysts to incorporate analysis of intangibles into their research and recommendations for a 5% cut of broker commissions, amounting to approximately EUR 4.5 million (USD 5.5 million).

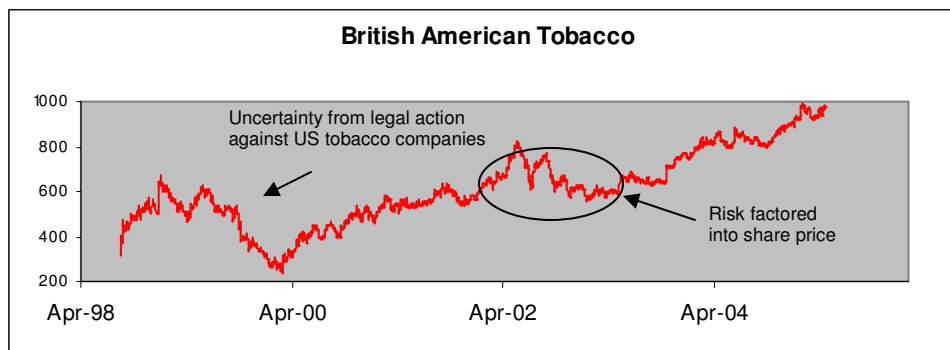
⁶ Mercer Investment Consulting (2005) 'Fearless forecast survey' www.mercerIC.com. Regional variations are noteworthy: More than 60% of US managers believe that integration of social and/or environmental factors will never become mainstream investment practice, while 85% of Asian and Australian managers believe it will.

⁷ www.generationim.com



Source: Bloomberg/SG Equity Research/CoreRatings

British American Tobacco’s shareprice showed high volatility in 1999/2000 when investors reacted with uncertainty to a lawsuit by the US government against major tobacco manufacturers. The pressure on the shareprice slowly lifted as the litigation risk appeared to be factored in by 2002.



Source: Bloomberg/SG Equity Research/CoreRatings

Looking specifically at brand value, Nike is a well-known example. Facing critical media exposure and consumer protest over labor standards in its supply chain, Nike’s brand value began to decline in 1999 and only started recovery in 2003/2004 following investment in its supply chain monitoring which has begun to reassure the market that the company can again protect and build its brand. The brand appeared strong enough to withstand the 2003 out-of-court settlement of a legal case over commercial speech. In 2004, Nike estimated that its brand accounted for more than 89% of the company’s revenue.

Nike Brand Value (USD billion)

1999	2000	2001	2002	2003	2004
8.16	8.00 (-2%)	7.60 (-5%)	7.70 (+2%)	8.17 (+6%)	9.26 (+13%)

Source: Interbrand

These examples indicate, among other things, the process of how shareholder and stakeholder reactions to poor management of corporate responsibility and governance risks in certain industries (such as tobacco and construction) become at least partially

factored into analysts' valuation models. However, the risks in other industries (such as media and telecoms) have arguably not yet been discounted for.

Ratings: a tool for managing external and internal expectations

CoreRatings has been working closely with leading industry, business and risk management experts as well as financial institutions to compare views on material qualitative risks and opportunities, their sectoral differences, and their valuation.⁸ As companies increasingly adopt business models that stress the importance of their intangible assets, it is not surprising that investors are calling on companies to more visibly demonstrate how they are managing this aspect of corporate value, how they are working strategically to build long-term value and differentiate themselves from competitors.

CoreRatings provides corporate responsibility and corporate governance ratings to companies upon their request. Publication of the rating is at the company's discretion: sharing the rating with investors helps them compare different companies' risk profiles and identify the companies most capable of managing current and future governance and responsibility risks. In other words, communicating a rating to the market is an effective (and resource efficient) way for a company to:

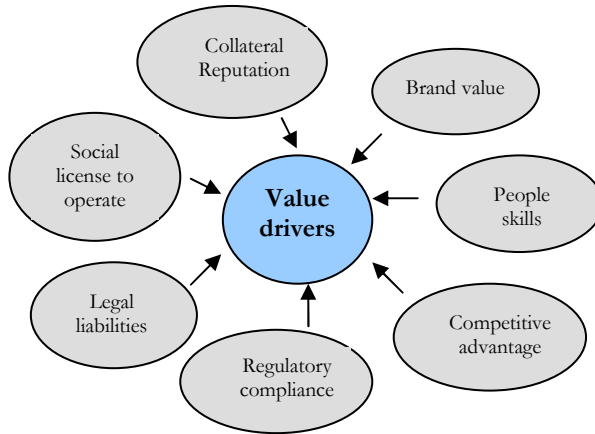
- manage investor perceptions of intangibles and related risks
- convey the quality of its risk management capabilities
- demonstrate compliance to regulators, and
- go beyond compliance to communicate the integrity of its risk management performance to broader stakeholders.

This in itself may serve as a significant differentiation advantage in a competitive market.

A rating is also a valuable diagnostic tool for use in companies' internal risk management processes. As an independent assessment of how a company is managing its material qualitative risks, a rating assists a company in refining and updating its risk register, including residual risks. For example, CoreRatings' corporate responsibility rating identifies the material environmental, social, employment and business ethics risks facing an industry and the individual company. Each risk is 'mapped' according to its probability (short and long term) and its potential effect on investment value.

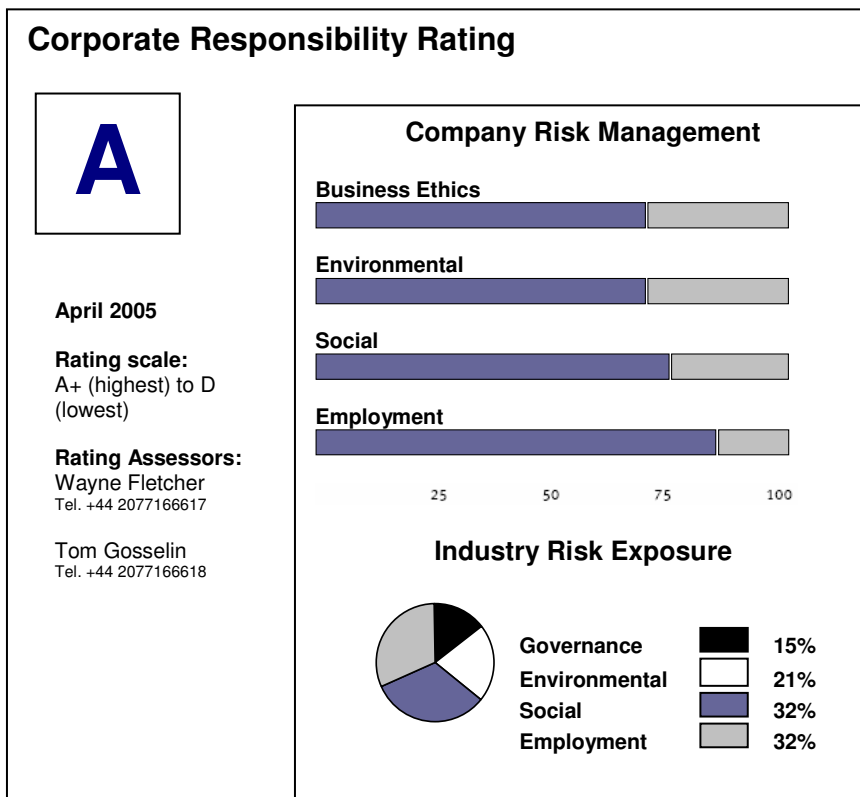
CoreRatings' methodology centres on the premise that the financial effect of these risks primarily materialises through intangible asset drivers such as brand, reputation, innovation and intellectual capital, as well as a company's ability to anticipate and manage its legal liabilities and regulatory compliance.

⁸ CoreRatings defines qualitative risks as all business risks of a primarily non-financial nature that have a material financial impact; referring to them as non-financial risks is essentially a misnomer, as they indeed have financial implications.



CoreRatings: Investment value drivers

Once the risks are mapped, we take an in-depth look at a company’s policies and their implementation, how management systems are validated as well as the quality of performance, disclosure and stakeholder dialogue. The subsequent analysis and scoring provide boards of directors with clear indicators of the qualitative risks they need to control and report on to shareholders and stakeholders. An objective assessment of a company’s risk profile – benchmarked against industry standards and international best practice – can help prioritise risk management activities internally and align them with broader business aims and strategy.



CoreRatings: Example of a rating summary

A critical factor in successful operational risk management is communication and documentation of strategy and policies across a company. Building internal awareness and identifying clear responsibilities for managing corporate responsibility and governance risks – and where necessary articulating the business imperative for establishing new structures, resources and processes – will serve to ensure buy-in from all employees, business units and management levels. This includes non-executive directors who may need to better understand a company's governance and responsibility risk profile and practices. An in-depth, independent review of how a company 'does its business' can strengthen and focus internal dialogue, distil the underlying values of a corporate culture and play a valuable role in the process of embedding credibility, transparency and accountability internally.

Focusing on materiality

To narrow the communication or value gap between company and external/investor perspectives and to prioritise internal risk management activities, the focus must be on materiality, on what is really relevant and warrants careful management in the short as well as the long term. Mandatory reporting requirements under the Sarbanes-Oxley Act and the UK's Operating & Financial Review (OFR) regulations call for directors to demonstrate due diligence and care in identifying and managing material risks. Various courts in the US and authorities in the EU have converged on a definition of materiality as that which may be material to shareholder interests. This narrows the focus down from the wide range of issues which broader social interest groups may define as material, but which once examined for their potential impact on the key intangible value drivers appear of marginal consequence in a risk management context of a particular company.

For example, while Exxon Mobil's current approach to addressing climate change issues is increasing the collateral reputation risk and expected to significantly affect its ability to maintain a competitive advantage, stakeholder requests for an amendment of the company's non-discrimination policy to include the category of sexual orientation are unlikely to present a material risk to shareholder value. (That said, the cumulative effect of a series of marginal risks may of course be significant and of material interest to shareholders. Also, it does not preclude acknowledgement of the information needs of other stakeholders).

At the same time, by defining materiality in terms of corporate/shareholder value, it broadens the scope of the risks to be identified, managed and reported significantly beyond traditional financial risks watched by directors. Not least for companies expanding into global markets and becoming exposed to new and complex risks that require understanding of international standards, local economic structures and cultural sensitivities. As some companies have learned the hard way, failing to manage, for example, international supply chain or business ethics risks can bring swift, unwanted global attention and tarnish otherwise solid brands and reputations. Corporate responsibility and governance risks are dynamic; they change over time and require updating and refinement to reflect changing knowledge, concerns and expectations.

Introducing mandatory requirements for comprehensive reporting on material corporate responsibility and governance risks may ward off concerns that companies refrain from disclosing such information due to fears of misinterpretation and litigation, particularly in

the US. The playing field is more level when all are subject to the same reporting obligations rather than various voluntary disclosure approaches. However, in the absence of consistent rules or where companies remain concerned that legal risks persist, an independent assessment of their risk profiles and management quality – which goes beyond what is already public information and draws on internal documentation and dialogue – may serve to demonstrate a commitment to transparency and provide assurance to shareholders and stakeholders that a company is managing its intangible assets to protect and optimise long-term shareholder value.

Intangible assets: a core management issue

In grappling with the intangible beast, one might do well to look closer at those proactive companies who are in fact already ‘making tangible’ some of the costs and benefits of managing corporate responsibility risks, measuring and demonstrating their bottom line impact, capitalising on opportunities, placing the whole activity squarely within their business strategy, and communicating their progress in a clear and consistent manner. These companies have already taught the elephant to dance.

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